ST 05-0001-PLR 04/22/2005 COMPUTER SOFTWARE

This letter discusses whether certain software agreements qualify as licenses of software. It also discusses whether certain software qualifies as custom software. See 86 Ill. Adm. Code 130.1935. (This is a PLR.)

April 22, 2005

Dear Xxxxx:

This letter is in response to your letter dated July 17, 2003, in which you request information. The Department issues two types of letter rulings.   Private Letter Rulings ("PLRs") are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete.   Persons seeking PLRs must comply with the procedures for PLRs found in the Department's regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter ("GIL") is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired.   A GIL is not a statement of Department policy and is not binding on the Department.   See 2 Ill. Adm. Code 1200.120.   You may access our website at www.ILTAX.com to review regulations, letter rulings and other types of information relevant to your inquiry.

Review of your request disclosed that all the information described in paragraphs 1 through 8 of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to COMPANY for the issue or issues presented in this ruling, and is subject to the provisions of subsection (e) of Section 1200.110 governing expiration of Private Letter Rulings. Issuance of this ruling is conditioned upon the understanding that neither COMPANY nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.   In your letter you have stated and made inquiry as follows:

On behalf of our client, COMPANY, we respectfully request the Illinois Department of Revenue ('the Department') issue a private letter ruling pursuant to 2 Ill. Adm. Code Section 1200.110 with respect to the following factual situation.

General Information

1.   Enclosed please find an original Form IL-2848 Power of Attorney, authorizing FIRM to represent Company before the Department of Revenue.

2.   This PLR is not requested with regard to hypothetical or alternative proposed transactions. The PLR is requested to determine the sales tax consequences of the actual business practices of Company.

3.   Company is not currently under audit with the Department with regard to this issue, nor is the Company engaged in litigation with the Department in regard to this or any other tax matter.

4.   The Department has not previously ruled regarding this matter for Company. Neither Company nor FIRM has submitted the same or similar issues to the Department on behalf of Company.

5.   Company requests that certain information be deleted from the PLR prior to dissemination to others. Company requests that its name, address, location of its headquarters, description of products being purchased and the name of its representative be deleted.

6.   Company knows of no authority contrary to the authorities referred to and cited below.

Statement of Facts

Company is a computer software developer based in STATE. The business has recently been sold and Company is contractually required to provide a tax clearance certificate to the buyer. Company is not currently registered to pay sales tax in Illinois.

Company has been in the business of licensing software to Illinois customers since 1989. During this time, Company has executed six software contracts with Illinois customers. Four of these contracts should be considered nontaxable software licenses and two of the contracts are for custom software.

Ruling Requested

Company respectfully requests that the Department issue a binding private letter ruling confirming that the six software license agreement described below are exempt from sales and use tax under Illinois law and regulations.

Relevant Authorities

Pursuant to 86 Ill. Admin. Code 130.1935(a), Illinois law provides as follows:

(1)   A license of software is not a taxable retail sale if:

(A)   it is evidenced by a written agreement signed by the licensor and the customer;

(B)   it restricts the customer's duplication and use of the software;

(C)   it prohibits the customer from licensing, sublicensing or transferring the software to a third party (except to a related party) without the permission and continued control or the licensor;

(D)   the licensor has a policy of providing another copy at minimal or no charge if the customer loses or damages the software, or of permitting the licensee to make and keep an archival copy, and such policy is either stated in the license agreement, supported by the licensor's books and records, or supported by a notarized statement made under penalties of perjury by the licensor; and

(E)   the customer must destroy or return all copies of the software to the licensor at the end of the license period. This provision is deemed to be met, in the case of a perpetual license, without being set forth in the license agreement.

Pursuant to 86 Ill. Adm. Code 130.1935(c), custom computer programs prepared to the special order of the customer are not subject to tax. To be considered exempt software, the following elements must be present:

(A)   Preparation or selection of the program for the customer's use requires an analysis of the customer's requirements by the vendor; and

(B)   The program requires adaptation by the vendor to be used in a specific work environment, e.g., a particular make and model of a computer using a specified input or output device.

Discussion

Software Licenses

In three Illinois contracts, Company granted the licensee a non-exclusive perpetual license to use the ABC System along with specific modules specified in the contract. (See Exhibits 1, 2 and 3) In the fourth Illinois contract, Company granted the licensee a non-exclusive right to use the XYZ System. (See Exhibit 4) In each of these contracts, the five requirements of 86 Ill. Admin. Code 130.1935(a) are met as follows:

1.   Each license is evidenced by a written agreement;

2.   Each agreement restricts the customer's duplication and use of the software;

3.   Each agreement prohibits the customer from licensing, sublicensing or transferring the software to a third party (except to a related party) without the permission and continued control of the licensor;

4.   Company permits the licensee to make and keep an archival copy of the software and this provision is stated in each of the license agreements;

5.   Each license is a perpetual license, obviating the need for a destruction or return provision in the agreement.

Thus, each of the four license agreements referenced above for either the ABC SYSTEM or XYZ SYSTEM products is exempt from tax in Illinois pursuant to 86 Ill. Admin. Code 130.1935(a).[1]

Custom Software

The remaining two Illinois agreements are for custom software with BUSINESS (which, together with its affiliates, is referred to as 'BUSINESS' in the agreements). The first custom software agreement is dated and grants BUSINESS a world-wide, perpetual, non-exclusive license to use, reproduce, modify, enhance and adapt the NAME System which was developed by Company. Pursuant to Section 4.2.a. of the agreement, Company agreed to modify the software and any updates as necessary for its proper operation on BUSINESS's system and in accordance with Schedule A and the Design Specifications. (See Exhibit 5, page 3)

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[1] Attached to each contract is a list of the 5 requirements and a citation to the provision in the contract where each requirement can be found.

Company and BUSINESS executed a Letter of Intent for a set of pricing related enhancements to the NAME SYSTEM. This Letter of Intent describes a phased project beginning with detailed analysis to identify the functionality required, the development of a specification document, followed by a finalized project plan based on such specifications. (See Exhibit 6) Company and BUSINESS subsequently executed an Addendum to the 1995 contract in March of 2000. (Enclosed as Exhibit 7 is an unexecuted copy of this Addendum) Pursuant to this Addendum, the 1995 contract was extended to encompass the addition of the PROJECT as more fully described in Exhibit A ('Specifications').

The impetus behind the PROJECT was BUSINESS's contractual obligations to provide accurate prices at each calendar month end for all assets under management for client portfolios. The Specification for the PROJECT is so extensive that it encompasses three volumes as follows:

Pursuant to 86 Ill. Adm. Code 130.1935(c), custom computer programs prepared to the special order of the customer are not subject to tax. To be considered exempt software, the following elements must be present:

(C)   Preparation or selection of the program for the customer's use requires an analysis of the customer's requirements by the vendor; and

(D)   The program requires adaptation by the vendor to be used in a specific work environment, e.g., a particular make and model of a computer using a specified input or output device.

A review of the BUSINESS agreements clearly illustrates the custom nature of these projects in accordance with the above requirements. The 1995 agreement includes a 'Project Plan' which identifies 107 tasks and deliverables required by Company. (See Attachment C to Exhibit 5) The PROJECT entailed developing custom software to consolidate and cleanse securities price data from various vendors for BUSINESS's office. The 29 page Project Plan is attached as Exhibit 8. These projects clearly required Company to perform an analysis of BUSINESS's requirements and to adapt the NAME SYSTEM and PROJECT for BUSINESS's specific work environment.

Attachments

Copies of the contracts discussed herein are enclosed as exhibits 1 through 8.

Conclusion

We respectfully request that the Department issue a ruling confirming, based on the facts and authorities presented above, that Company's six software license agreements are exempt from Illinois sales and use tax.

If the Department cannot so conclude, I request that the Department contact me to determine what additional information is required or allow the taxpayer to rescind the ruling request. Please contact me at the above number with any questions or to schedule a meeting to discuss any aspect of this ruling request. We appreciate your response on these issues.

RESPONSE

        As set forth in 86 Ill. Adm. Code 130.1935(a), "[a] license of software is not a taxable retail sale if:

A)   it is evidenced by a written agreement signed by the licensor and the customer;

B)   it restricts the customer's duplication and use of the software;

C)   it prohibits the customer from licensing, sublicensing or transferring the software to a third party (except to a related party) without the permission and continued control of the licensor;

D)   the licensor has a policy of providing another copy at minimal or no charge if the customer loses or damages the software, or of permitting the licensee to make and keep an archival copy, and such policy is either stated in the license agreement, supported by the licensor's books and records, or supported by a notarized statement made under penalties of perjury by the licensor; and

E)   the customer must destroy or return all copies of the software to the licensor at the end of the license period. This provision is deemed to be met, in the case of a perpetual license, without being set forth in the license agreement."

Following these criteria, it is the Department's position that the agreements submitted with this request for a Private Letter Ruling meet the requirements to be considered licenses of software.

As set forth in 86 Ill. Adm. Code 130.1935(c), "[c]ustom computer programs prepared to the special order of the customer are not subject to tax under the Retailers' Occupation Tax, Use Tax, Service Occupation Tax or Service Use Tax. To be considered exempt software, the following elements must be present:

A)   Preparation or selection of the program for the customer's use requires an analysis of the customer's requirements by the vendor; and

B)   The program requires adaptation by the vendor to be used in a specific work environment, e.g., a particular make and model of a computer using a specified input or output device."

Based upon a review of the BUSINESS agreements and attachments submitted, it is the Department's opinion that the SOFTWARE qualifies as custom software and is not subject to tax.

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation, or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

I hope this information is helpful. If you have further questions concerning this Private Letter ruling, you may contact me. If you have further questions related to the Illinois sales tax laws, please visit our website at www.ILTAX.com or contact the Department's Taxpayer Information Division at (217) 782-3336.]

Very truly yours,

Martha P. Mote
Associate Counsel

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